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BANK DEFALCATIONS—THEIR CAUSES AND CURES

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The banking business offers greater temptations for the abstraction and wilful misapplication of assets than any other calling. This can be explained by the fact that the only commodity dealt in is money, or that which is payable in money, rather than commodities of general use, which to be of any value to the person acquiring them must be converted into money. This conversion is always attended with some difficulty and risk, as the commodity can ordinarily be identified. In the case of money, however, no conversion is necessary and this element of risk is eliminated.

Bank defalcations can be divided into two classes. Those for which the officers of the institution are responsible, and those made by the clerical force. The defalcations by officers can be traced to a variety of causes, among which might be mentioned the following:

The using of bank's funds to promote enterprises in which the officers of the bank are financially interested.

The using of bank's funds for speculation in stocks, grain, cotton, etc.

The using of bank's funds for gambling purposes, for betting at the race track and for extravagant living.

The advancement of the political ambitions of its officers.

Negligence of directors in allowing officers to use the funds, under the guise of loans, to a criminal extent.

Assistance rendered by the clerical force of the bank through their lack of observation of the criminal acts of the officers or their criminal silence.

The want of a rigid enforcement of the criminal laws by the courts.

In a recent address of the Comptroller of the Currency, Hon. William Barret Ridgely, at the convention of the Illinois State

Bankers' Association, among other forcible, sound doctrines annunciated, said:

No national bank whose officers strictly obeyed the National Bank Act ever failed, not one. It may almost be said that not one which did not make loans in excess of the 10 per cent. limit has ever failed. The practically universal rule is that all failures are due to excess loans to one interest or group of interests, generally owned or controlled by the officers of the bank itself.

In the Comptroller's office, when any question is raised in regard to a bank and the examiner's reports are sent for, the first thing looked at is loans to officers and directors, and then excess loans. If the officers owe the bank little or nothing, and there are no excess loans, it is seldom necessary to look much further, for the bank is almost sure to be found in good condition. There are rare cases of sudden flight of bank officers, disclosing unexpected forgeries, defalcations or theft of money, leaving the bank a wreck, but these are almost invariably the last of a chain of misdeeds beginning with the loaning of undue and illegal amounts by the officers to themselves or concerns in which they are interested.

No one familiar with the subject will controvert the above statement. The examination by the department of justice of our government, made by its expert examiners, of the books of failed national banks, confirms the above statement and in addition shows that, without a single exception, had there been an expert examination made of the books of the bank the shortage, by whatever name it is designated, would have been discovered long before it grew to anything like the proportions that many of them did before the bank collapsed.

Among the first things that the average promoter does is to interest some officer of the leading bank in the locality where the business is to be located, or the stock or bonds of the corporation are to be sold to the public. In some instances the officer is prevailed upon to invest all of his available cash in the enterprise, which, in many cases, is a comparatively small amount, but which represents many years' savings from a small salary; while in others he is made a present of a certain amount of the stock of the corporation, which, he is assured and verily believes, will be the beginning of his march along the financial road which will shortly land him at the millionaire's mile post.

In many cases the bank officer is made an officer, a director or a member of the advisory board of the corporation, which fact is

heralded to the world with all the advertising skill of the promoter, and upon the reputation of his good name many are induced to become stockholders. This is more strikingly the case in smaller cities and country localities, but the large cities are not free from it by any means.

Many a defalcation which has caused the bank's failure is traceable to its officer's interest in some outside enterprise, and the beginning of his downfall dates from the day he made the first investment. One of the main reasons which animated the promoter of the enterprise in financially interesting the banker was that if at any time the concern required financial assistance, which is invariably the case, it could readily be obtained through him from the bank of which he was an honored and trusted officer. Experience shows that what was at first a small financial assistance soon increases in amount until the point is reached where it means disaster to all parties interested if additional aid is not given. Then it is that the demand for money must be met to prevent the bankruptcy of the corporation, which means the loss not only of the money invested by the officer and his many friends, but also the loss of his reputation as a financier and a banker of integrity.

It often happens that instead of becoming financially interested in new projects or outside business enterprises, the bank officer succumbs to the seductive influences of speculation. He tries his hand in the stock, grain or cotton market with the belief that in this way he can amass a fortune in a short time and without effort.

He pursues the same method that is followed by those who buy or sell stocks, grain or cotton on a margin. His whole idea is to "get rich quick," and in order to accomplish this he either buys or sells the largest amount possible with the smallest amount that his broker will accept as margin. A slight adverse change in the market price of the commodity or security in which he is speculating wipes out his margin, and a call from his broker for additional margin to carry the transaction must be met. Having exhausted his own money, and being convinced that his ideas as to the future course of the market are correct, he makes the false step of "borrowing" money from the bank and using it as margin with his broker.

It is only a question of time, varying according to the size of his operations and the fluctuations of the market, before he is hope-

lessly involved and financially unable to return the money of the bank which he has used. He now speculates more wildly than before, and upon a much larger scale, with the hope that one fortunate turn of the market will enable him to make enough money to square himself with the bank. In his case history only repeats itself. He went into the market as a lamb and in consequence is thoroughly fleeced.

In some cases the gambling house presents more attraction than the stock, grain or cotton market, but it is not often that this means of acquiring wealth is resorted to by the bank official, as it is not considered by many as reputable as speculation.

Closely associated with the gambling house is the race track, which to some has a fascination that is almost irresistible. The number of persons who bet upon a certain horse to win, upon a "dead sure tip," can be counted by the myriads. This method of gambling is resorted to to a greater extent by the clerical force of the bank than by its officers.

A large bank in an eastern city was wrecked through the speculation of its president in stocks; another one through speculations of its cashier in the same market. Some years ago a large bank in the middle West was wrecked by its vice-president in an attempt to corner the wheat market; while a bank in a southern city was wiped out of existence by its president's and cashier's speculations in the cotton market. The number of cases that could be cited are innumerable, and there is not a section of the country that has escaped. The number of bank wrecks piled upon the financial beach is a silent monument to this truth.

Many bank officers feel that they must maintain a certain social position in the community in which they live, and to do this many live beyond their income. They attempt to indulge in the extravagances practiced by their wealthier business associates, with the result that they use the bank's money with which to do it. The failure of a certain national bank revealed the fact that its cashier was indebted to it in a sum exceeding one-half of its capital, and that a large portion of the money obtained by him from the bank was used in extravagant living. He maintained a palatial home; his family dressed extravagantly; they entertained lavishly; he kept many fast horses, and indulged in various other forms of expensive luxury. All of this was ostensibly done on the moderate salary he received.

Some bank officers labor under the delusion that to be a factor in the community in which they live, they must enter the "political arena." They strive for a high political office. The bank officer soon exhausts all of his own money in his campaign, and next uses the money of the bank which stands ready at hand. The desire for political preferment has turned the head of many a man, and bankers are not insensible to its influence. The ambition of a president of a certain national bank to be the political leader of his party and the mayor of the city in which he lived, caused him to use the bank's funds to further that end to such an extent that the bank was forced to suspend, which entailed a severe loss upon its depositors and stockholders.

Bank officers whose directors do not direct are very often tempted into the use of bank funds under the guise of loans. In all probability they would not have broken the law if the persons selected by their fellow-stockholders to hold the office of director had been directors in fact and not in name only. A director is a trustee and he cannot fulfil the trust he assumes without knowing that the affairs of the bank are being properly administered. How can he do this when he leaves the management almost exclusively to the president or cashier? The number of banks wrecked by its officers because of directors not directing is exceedingly large.

No president, vice-president, cashier or assistant cashier of a bank can use the funds of the institution for his own use without the same being known to at least a portion of the clerks, and it is through their silence, either wilful or the non-observance of what is being done in their presence, that bank officers are enabled, and in many cases encouraged, to take the funds of the bank. If bank clerks would do their full duty there would be fewer cases of defalcations by bank officers than at present.

It is an undeniable fact that the laxity with which the criminal laws of our land are enforced by many of the judges of our courts has much to do with encouraging bank officers to criminally use bank funds. They see in too many cases how difficult it is to convict a bank official who has misappropriated bank funds when defended by a shrewd criminal lawyer, and they are therefore willing to take the chances of detection, and if detected the results of a trial before a judge whose interpretation of the law, the admissibility of evidence and the charge to the jury are all in favor of the

accused. It is only the fear of the law that keeps those from violating it who are not actuated by high motives of right, and judges should be loath to have the charge of the lax enforcement of the law laid to their doors.

While the bank officer is surrounded on all sides by temptation, and some criminally use the bank's funds, one must not for a moment think that they are the only ones connected with the institution who are subject to temptation and who, far too often, listen to the voice of the tempter and become defaulters. Every clerk in the bank, whether he handles a dollar of the bank's money or not, is subject to many, if not all, of the temptations that beset his superior officer. The defalcations by the clerical force of banks can be traced to nearly all the causes enumerated as being the cause of defalcations by officers, and also to a variety of other causes, among which are the following:

1. Temptations offered by loose methods of conducting the business of the bank or of keeping its books and accounts.
2. The lack of proper supervision by officers and directors.
3. The criminal using of bank funds by its officers without detection and punishment, encouraging clerks to do likewise.

Many a bank clerk who has been unfaithful to his trust and has used the funds of the institution with which he was connected for speculation in the stock, grain or cotton market, or for games of chance at the gambling house, or for betting at the race track, or for extravagant living, etc., has been encouraged to take his first false step by the loose manner in which the affairs of the bank were conducted and its accounts kept. He saw the slip-shod way in which things were done by every one connected with the bank, that clerical errors in the books were not located and corrected, and that general mismanagement prevailed. Is it any wonder that he used the funds of the bank and took the chances of detection with such a condition of affairs surrounding him? The marvel is that, under such conditions, more do not succumb to temptation.

Another cause of defalcation by bank clerks can be ascribed to the lack of a proper supervision of their work by the officers and directors of the institution with which they are connected. The bank may be well managed in all other respects. The officers and directors may loan its funds judiciously and well, be very attentive to the patrons of the bank and on the alert to add to its already large

list of customers. But all of this will not counterbalance the evil results arising from the lack of supervision. The number of defalcations traceable to this cause is undoubtedly large.

In detailing some of the causes of bank defalcations by the clerical force, the criminal using of bank's funds by officers without detection and punishment is one which should not be overlooked. Many a bank clerk who sees the president or cashier of the bank with which he is connected using its funds in speculation or business projects to a criminal extent, and doing so with perfect impunity, as far as the board of directors is concerned, is induced to do the same thing. He sees how easy it is for the officer to get the money of the bank, and he learns the methods he adopts in an endeavor to conceal the fact. He hears of the enormous profits that the officer has made in speculation and what not. He knows that this has been going on sometimes for years without discovery. He therefore concludes that what the officer can do the clerk can do also. He takes a "flyer" in the market and uses the funds of the bank to margin the transaction.

The bank clerk defaulter, when his crime is discovered, is generally brought to the bar of justice to answer for his misdeeds. He is usually convicted. He has no influential associates to use their power to shield him. He has no money or wealthy relations or friends who are willing to furnish money with which to employ able criminal lawyers to defeat the ends of justice. The bank officer having what the bank clerk lacks, often escapes the just punishment his criminal acts demand.

The reader must bear in mind that there are no cures for all kinds of defalcations, but they may be reduced to a minimum if banks are properly managed. The cures that are suggested for defalcations arising from the causes discussed are as follows:

1. Directors directing, being more than figure-heads in the management of the bank's affairs.
2. The employing of a sufficient clerical force to properly record the daily transactions of the bank. The non-use of all short-cut methods of accounting which are at the expense of safety.
3. The using of a system of accounting that is surrounded with every known device for safety.
4. The thorough overhauling of the books of every department of the bank by expert accountants at irregular and frequent periods.

5. The realization by directors that examinations made by the official examiner afford little protection against dishonesty of employees, and at best is too hurriedly made to be of much value.
6. Prohibiting bank officers from borrowing money from the bank with which they are connected, except upon the most approved collateral, and the approval of such loans by the board of directors by a formal vote at a meeting of the board.

The number of directors of the banks in the United States who do not direct is much larger than might be supposed, and usually it is the bank where directors are impotent that is looted by one or more of its officers or clerks. Where directors direct, defalcations are almost unknown.

The employing of a sufficient clerical force to properly record the daily transactions of the bank is a cure for defalcations that must not be ignored. Too many officers of our banking institutions are attempting to conduct their business with an inadequate clerical force who, to keep up their work, resort to every kind of hieroglyphic entry that their fertile brain can devise. The non-use of all short-cut methods of accounting, which are at the expense of safety, is a cure for defalcations that can be prescribed to advantage. A large number of defaulters resort to false entries upon the books to conceal their shortage. The use of short-cut methods of accounting makes falsifications easier of accomplishment and harder of detection. Short-cut methods are the bank thief's friend and are welcomed by him. Any one familiar with the English system of bank accounting knows that such methods are not tolerated, and if our banks, instead of gradually drifting away from the point of safety, would adopt the English methodical methods of recording transactions they would be better off in the long run. Defalcations in English banks are almost unknown. Does any one for an instant suppose that the English bank clerk is more honest than his American cousin?

The using of a good system of accounting is undoubtedly a cure for many kinds of defalcations. The system used should contain every known device for safety that the ingenuity of the expert accountant can devise. It should fit the requirements of the business. A system that would be a success in one bank would be a flat failure in another and *vice versa*. The volume of the business

transacted, the method of conducting it and the number of clerks employed to handle it are all factors that must be considered in devising a system of accounts. The system of accounting that was used forty years ago, and in a number of cases used to-day, is almost worse than useless. It lacks the safeguards which the improved systems of to-day provide.

The thorough overhauling of the books of every department of a bank by expert accountants at irregular and frequent periods is considered by those who have made a study of the subject as being one of the best, if not the very best, cures for defalcation that can be suggested.

Comptroller Ridgely in commenting upon this subject, in his address previously referred to, said:

The directors should have frequent thorough examinations made by committees of the board or experts employed for that purpose. These should be made independently of the active officers of the bank and with all the incredulity of the proverbial Missourian, everything should be shown and no man's word taken for anything.

Every clerk and every officer of the bank should be examined and checked up as thoroughly as possible, and required to show the examining committee or the auditor just how the matters in his charge stand. No man who is in a position of trust has any right to resent such an examination, and one who has a proper appreciation of the relation he bears to those who have reposed trust and confidence in him will welcome such an opportunity to show that he has been faithful and efficient.

If all boards of bank directors would do their full duty in the way here outlined, bank failures would almost come to an end. Banks would, of course, make losses and occasionally one might fail, but it would be rare, and the result of very unusual bad judgment and incapable management. We would very seldom have such sudden and sensational failures of banks, looted from the inside by men who have stood high in their communities, and even thought to be models of honesty and trustworthiness.

The Hon. James H. Eckels, ex-Comptroller of the Currency and president of the Commercial National Bank of Chicago, in speaking upon this subject, said:

I believe that a bank cannot make a better investment than to have an independent audit made by an expert, both for the benefit of the officers and directors. To such independent audits can be given more time and a more complete analysis of the condition of the bank being examined than under the ordinary examination made by the directors without the aid of an expert.

The Hon. Charles G. Dawes, ex-Comptroller of the Currency and the president of the Central Trust Company of Illinois, of Chicago, expresses himself upon this subject as follows:

In reference to the advisability of a periodical examination of the affairs of banks and trust companies, made by experts, for the benefit of the officers and directors of such institutions, I will state that I deem such a course as most advisable. While in the larger cities the public examiners have, as a rule, a compensation sufficient to enable them to make a proper examination, the National Banking Act in its provision for compensation of examiners outside of the central reserve cities in effect places a premium upon hasty and incomplete work. This defect has been recognized by most of the Comptrollers of the Currency, and the attention of Congress invited to it. However, both in the central reserve cities and elsewhere, a periodical examination by experts of the affairs of banking institutions I deem important.

The examination by the expert accountant furnishes an additional protection to the banker against dishonesty; it is a necessary supplement to the work of the official examiner; it improves the tone and efficiency of the working force; it improves the system of book-keeping; and it increases the confidence of the depositors and stockholders.

Few realize in how many ways a bank may be defrauded by its officers or clerks. A large volume could be written on "how to rob a bank" without exhausting the subject. There are few banks in the United States which have not suffered some loss from the dishonesty of an officer or clerk. Why will banks wait until they have sustained a severe loss through the dishonesty of a trusted employee before having their books examined by an expert accountant? To the prudent business man the question is unanswerable. There is no bank which does not receive full value in the security of its business for the money which it spends on an audit by an expert accountant.

The official examinations as now conducted are of little value against the dishonesty of employees. They are not thorough enough and are too hurriedly made. There are 75 national bank examiners in the United States to make 10,914 examinations each year, or an average of 145 to each examiner. Assuming that all the examiners are steadily employed every day in the year, excepting Sundays and legal holidays, when the banks are closed, they can devote on an average only two days to each examination. Even the largest

banks, with hundreds of employees and thousands of accounts, are examined in a few days.

The audit of bank books by expert accountants is comparatively a recent development, but it is rapidly being adopted by conservative bankers everywhere. It furnishes the best safeguard against dishonesty, the best means of improving the administrative service of the bank, and is a strong bid for public confidence and support. The bank that surrounds itself with every safeguard is in the strongest position to command the banking business of the community.